Department of Business
&
Economic Development

Responses to the DLS Analysis of the FY 2005 Budget Allowance (Operating & Capital)

Prepared for the Hearing before the House Appropriations Subcommittee on Education and Economic Development.

February 12, 2004

OPERATING BUDGET RESPONSES

1. **Reduce general funds for grants in the Division of Business Development.**

   Reduction Amount: $150,000 GF

   Response: DBED opposes this reduction. As the analyst reports, this grant of $150,000 supports the Baltimore Symphony Orchestra's Overseas Tour. This level of support is required by the budget committees. There were no additional resources provided to fund this activity. Therefore, if the $150,000 is no longer required for support of the BSO, DBED believes that the funds should be available for the original budgeted purpose - support of the important economic development advertising & promotion activities.

2. **Add budget bill language to require DBED to provide fund data information for the business assistance programs in future budget request materials.**

   Response: Concur.

3. **Reduce general funds by 50% for business assistance programs.**

Reduction Amount: $5,275,000 GF

Response: DBED strongly opposes this reduction.

A reduction in the $300,000 GF for the *Maryland Economic Assistance Fund (MEAF)* would severely impair DBED's capability to provide direct loans and indirect support through local Revolving Loan Funds (RLF) to new and existing small and disadvantaged businesses. DBED disagrees with the DLS recommendation and believes that it further threatens DBED's efforts to facilitate the development and growth of small businesses in our State.

The MEAF program is an established small business resource that makes loans to new and existing small businesses that are unable to qualify for loans from traditional sources of financing. The program also provides funding assistance to support local government small business Revolving Loan Funds. Although MEAF is not as well known as some of the DBED's other resources for businesses, the program has been an effective financing resource for small businesses that cannot qualify for private financing, and local government revolving loan funds. The state fund portion of MEAF is accessible to all counties.

The *Maryland Small Business Development Finance Authority (MSBDFA)* needs the full GF allowance of $1.75M in FY 2005 to simply maintain its existing funding level to Maryland's small and minority businesses and to accommodate even a portion of the current trend of new applicants. A reduction in the Governor's $1.75 M proposed allowance will place the programs' solvency in dangerous territory – causing program management to scale back the number of applications it processes or to reduce the maximum loan amount provided to any one company.

The Governor' Allowance for MSBDFA will support the current growth trend, particularly in the Contract Financing, Loan Guaranty Fund and the Surety Bond Program. These programs will have to continue to operate well above the acceptable leverage ratios of 3 times their cash balances.

More specifically, as of December 31, 2003, the leverage ratios in the Loan Guarantee Fund and Surety Bond Program were 4.52 and 3.46, respectively. In raw numbers, the gross guaranteed loans of $4.16 M are being secured by net cash (after operating expenses) of only $967,266. The surety bonding lines of credit, which total $5.34 M are supported by $1.6 million. The programs had $560,000 and $760,000, respectively, in commitments pending closing at that time – and another $1.88 M and $1.66 M, respectively, pending approval by the Authority. Meanwhile, the Authority has approved $940,000 in new guarantees and $751,000 in surety bonds so far this year (through February 9th). Consequently, we estimated that by June 30, 2004, based on this data, that the programs' leverage ratios will be 7.00x and 4.97x, respectively.

The banks are constantly nervous about doing business with MSBDFA because the funds are so highly leveraged. This issue is aggravated by the fact that MSBDFA's guarantees are not backed by the full faith and credit of the State. We have recently (January, 2004) established a relationship with BankAnnapolis, which has already submitted three (3) guarantee requests totaling $1.25 M. The surety companies have done business with MSBDFA only once (April 2002) in the past **four** years because of the condition of the industry and insufficient funding.

The Contract Financing Program is also ballooning beyond its parameters with $2.12 million supporting $4.9 M outstanding lines of credit (a leverage ratio of 2.34X. While only $1.35 M was outstanding as of December 31st, the requests for loan advances could easily double at any time – rendering the program insolvent. Even a 50% increase would deplete the program's fund balance. Worse yet, the program had more than $1 M of loans pending closing. By the end of this fiscal year, we expect the loans in the portfolio to equal more than 3x its fund balance.

The Equity Participation Investment Program had a net cash balance of $1.69 M at December 31st with $425,000 in approvals pending closing and another $1.25 M awaiting approval by the Authority. In addition, an application was recently submitted by an existing portfolio company for a $250,000 increase in its financing.

In conclusion, MSBDFA is a program that generates tax revenue for the state and county governments in amounts equal to more than 3x its operating expenses. Any reduction in the proposed allowance would render a critical blow to one of the only sources of financing for small disadvantaged businesses, and minority businesses in particular.

The Department understands the value of small business programs such as MEAF and MSBDFA to Maryland's economy and is committed to efforts that support the development and growth of small businesses in Maryland.

DBED contends that the Governor's allowance for FY 2005 of $8.5M for the *Enterprise & Challenge Investment Programs* responds to both the fiscal challenges facing the State and the important economic development and investment impacts that these programs continue to have in on the State's technology and biotechnology sectors. The Enterprise Investment and the Challenge Programs are important economic development engines for the State. As of January 30, 2004, the program had disbursed or committed $4.5M. This activity utilizes 90 % of the current appropriation with many more active pipeline projects. And we continue to evaluate and analyze new deals every day. This indicates that there are significantly more qualified deals out there than the programs are able to fund. The result is that this already competitive process has become extremely competitive as only about 1 in 10 business plans result in funding. It is highly likely that strong technology and biotechnology companies are not getting funded because of the size of this year's budget and this impacts the region in terms of job creation and the development of economic clusters. The Governor's allowance provides the additional funds needed to maintain our high standards and increase our ability to participate in exceptional technology and biotechnology deals.

The business assistance programs are a key differentiator between Maryland and other neighboring states. Pennsylvania, Delaware, West Virginia and Virginia do not have similar investment vehicles or a proven investment track record. In recent years, the Enterprise Investment Fund has returned in excess of $51M to the State through the sale of stock. More and more frequently, these programs are used as a recruiting tool to technology companies throughout the region to attract companies to Maryland.

The Governor's allowance funding level provides the resources to continue to be competitive with neighboring states in terms of recruiting and retaining the most promising technology companies to grow the Maryland economy.

Although the venture industry is beginning to show signs of recovery in terms of activity and deal size, there remains a lack of funding for companies in the earliest stages of growth. Our history with companies shows that a large funding gap still exists between early stage funding and the first round of institutional funding. The MD Enterprise Investment Fund and Challenge Program fill a critical void in the funding lifecycle of a company. The Challenge Program works with companies at the earliest stages of their development. The Governor's allowance provides the resources necessary for continuity of funding for the companies that are growing rapidly, creating jobs and accomplishing milestones.

The State of Maryland, through Maryland TEDCO, universities and federal labs has been very proactive about fostering technology commercialization and nurturing seed stage technology companies. The State has really placed emphasis on this as an important driver in our economy. This effort has impacted our business assistance programs in that we are seeing an increase in the number of deals that come to us for review and possible investment.

4. Reduce general fund grant expenditures in the Maryland State Arts Council.

Reduction Amount: $3,142,688 GF

Response: DBED opposes this reduction. If implemented, the DLS recommended reduction would mean a 28% reduction in the overall general fund appropriation from the current FY 2004 level general fund appropriation. This reduction would follow on the heels of the 8.5% cut MSAC sustained from FY 2003 to FY 2004, and an 11% cut from the previous year's general fund appropriation. This proposed reduction of $3.1 M would reduce MSAC's general fund appropriation to the lowest level in seven years – FY 1998 was $8.2 M.

The Arts Council has had a long-standing goal of providing up to 10% of the operating expenses for those organizations achieving the highest level of excellence. In FY 2004, the funding cap was 6.56% of operating expenses, down from 7.25% the year before. A reduction of $3.1 million in general funds would yield a devastating blow to the funding cap. The cap would be reduced to the lowest percentage of state support since the inception of the 10% goal: 4.6%. The Baltimore Symphony Orchestra, for example, would face a $500,000 reduction in operating support. Every county arts council statewide would lose at least $17,000 in annual operating support.

The MSAC provides general operating support to over 250 organizations. These organizations rely on the State as one of the few sources of unrestricted operating support. State support is also a powerful leveraging tool. For every dollar the Arts Council gives, it leverages another $14 in other public and private support. To protect the State's investment in facilities, such as the Clarice Smith Performing Arts Center, Creative Alliance, Round House, and Imagination Stage, it is imperative that appropriate levels of operating support be available for these and other organizations.

Cuts in the MSAC budget would be felt in every county of the state. In each county, there is a designated local arts council that receives a significant block grant from MSAC. Oftentimes, the arts council is the primary presenter of arts activities and arts services in the county. Any reduction in funding would have a direct effect on programming and staffing.

A 28% reduction in state funds would impact every MSAC program, eliminating some, and drastically cutting others:

<u>Grants to Organizations</u>

The cap would drop from 6.56% to approximately 4.6%, the lowest level since the foundation of the 10% goal set in FY1991. This would further destabilize the funding mix of arts organizations, causing program and staffing cuts that would undercut the tremendous growth and development of the arts industry in the last decade.

<u>County Arts Council</u> block grants would be cut by more than $17,000. These cuts would impact programs and staffing levels so hard won in the last decade.

<u>Arts in Education Program</u> would be cut by 25%, reducing the number of performance and workshop services to students and the broader school community.

<u>Arts in Communities</u>

Program funds would be cut by 50%, reducing support for new and emerging arts presenters at the community level.

<u>Technical Assistance Program</u>

Program funds used to assist arts organizations in capacity building would be eliminated.

<u>Individual Artist Awards</u>

Reduce ability of MSAC to encourage and nurture artistic excellence by decreasing significantly the number of individuals that can devote energies to creating new work.

Economic Impact of the Arts in Maryland
Since 1995, the total economic impact of the arts has grown from $360 million to $898 million in FY2002. This translates into 16,000 jobs, $32 million dollars in state and local income taxes, and $156.6 million annual operating expenditures by non-profit arts organizations. Over 10.9 million people attended arts events in FY2002. Investing in the arts is an investment in Maryland's future. Public support for the arts makes sense. A vibrant cultural community is attractive to businesses looking to locate here; a bustling cultural scene attracts a young, educated work force; arts in our schools help develop critical thinking skills and inspire creativity; and, the arts can provide a sense of community identity.

From the National Governor's Association Center for Best Practices:

The Role of the Arts in Economic Development
"Arts programs have served as components of high-impact economic development by assisting state and local government in …restoring and revitalizing communities by serving as a centerpiece for downtown redevelopment and cultural renewal; creating vibrant public spaces integrated with natural amenities, resulting in improved urban quality of life, expanded business and tax revenue base, and positive regional and community image;…"

The Impact of Arts Education on Workforce Preparation
"The arts provide one alternative for states looking to build the workforce of tomorrow – a choice growing in popularity and esteem. The arts can provide effective learning opportunities to the general student population, yielding increased academic performance, reduced absenteeism, and better skill-building."

5. **Delete general fund support for the Economic Development Opportunities Program Fund (Sunny Day).**

   Reduction Amount: $2,000,000 GF

   Response: DBED opposes this reduction. This recommendation would eliminate $2 million of general fund support for the Sunny Day program. The DLS analysis states: “Due to the transfer of $10.0 million in FY 2003 and the reduction in general fund appropriations of $3.0 million in FY 2004, the fund balance has decreased 78.4% from $3.5 million in FY 2003 to $762,000 in FY 2005. During FY 2003, three projects were financed totaling $6.7 million and five financing incentives approved totaling $15.3 million.” In view of this level of activity, a request of $2M GF for FY 2005 is a very modest but important step toward re-capitalizing this important and highly visible economic development financing tool.

   This is a program that is intended to support “extraordinary” economic development opportunities and is highly visible to businesses that are considering Maryland as a place to relocate or expand.

   For example, recently a proposal has been made for $3 million of Sunny Day assistance for a headquarters to relocate to Maryland with 900 new jobs and a capital investment of $160 million.

Additional Operating Budget Issue Responses:

The Department should brief the committees on the various changes that have been incorporated in the FY 2005 MFR and how these changes more accurately reflect the department's impact on the State's economy and business climate.

Response: As previously stated in our formal response to the DLS-OLA review, the Department agrees with the recommendation that DBED can improve on the existing internal controls processes used for the preparation and review of both divisional and departmental performance measure data. The department also agrees with the recommendation that DBED should develop standardized terminology for both Departmental and Divisional performance measures as well as more precise method of reporting performance measure definitions for Budget Book presentation. We believe that the FY DBED Managing for Results (MFR) materials summarized in the Governor's budget for FY 2004 & FY 2005 represent significant steps in making those improvements.

We have also streamlined our FY 2005 presentation in response to legislative concerns regarding the length of MFR materials and the lack of sufficient focus on key performance measures.

DBED remains convinced that the current practice of reporting the most significant program performance output & outcome measures projected to occur as a result of the specific approvals in the particular fiscal year is the most appropriate, consistent, and accurate method of reporting.

DBED was asked to comment on the following DLS Observation: "The Maryland Economic Adjustment Fund's Operating Expenses Increase Substantially".

Response: ***DBED disagrees with this observation***.

The budgeted operating costs (direct & indirect) of MEAF within the Governor's budget actually decline by approximately $32,000 in FY 2005 $542,063 from the FY 2004 level of $573,980. The comparable figure for FY 2003 for the combined operations of MCAFF & MEAF is $755,601. In comparison with that year we are expecting to realize a savings of $213,538. These savings are now available for additional financial assistance to small businesses across the state.

As was discussed in previous years with DLS staff, DBED did not receive any new staff positions to operate the MCAFF program when it was established. The same staff also provides the services under the MEAF program. It is well known that small business lending and financial assistance is highly labor-intensive. Given the high priority placed on supporting the financing needs of the Maryland small business community, DBED had no other funding option when the MCAFF program was eliminated. The current budget allowance reflects our commitment to continue to meet this important state economic development need in a cost effective manner.

CAPITAL BUDGET RESPONSES

1. **Add the following language: Provided that beginning July1, 2004, DBED shall establish separate subprograms and costs centers through the State Budget & Financial Management Information System for the Brownfields Revitalization Incentive Program, and the Smart Growth Economic Development Fund (One Maryland) contingent upon the enactment of legislation to establish One Maryland as a component of the Maryland Economic Development Assistance Authority Fund.**

Response: Concur with concerns. The Department concurs that with the One Maryland capabilities consolidated into MEDAAF that it is important to guarantee continued legislative oversight of the One Maryland activity. In order to provide this continued oversight, the proposed legislation to consolidate the programs establishes a distinct & separate capability for assistance to “Qualified Distressed Jurisdictions”. This will allow for all One Maryland activity to be tracked and identified in reporting to the legislature.

The Department contends that a clearly defined BRIP program within MEDAF (as it is currently) allows for appropriate levels of legislative oversight. The current MEDAAF Annual Report to the legislature identifies the number and amount of BRIP loans and grants in the portfolio. DBED will work with DLS & DBM to develop an expanded format for reporting BRIP activity that will enhance the legislative oversight.

The concept of segregating funds for One Maryland or BRIP, while achievable, may be some what problematic. Given the modest funding level dictated by current budget constraints, establishing pools of funds dedicated to a single purpose may be unduly restrictive on DBED’s ability to assist the most worthwhile economic development opportunities.

Additional Capital Budget Issue Responses:

DLS recommends that DBED comment on its declining loan interest and repayment fund balance and the accuracy of its fiscal year 2004 and 2005 estimates.

Response:

The decline in the level of principal and interest repayments is primarily the result of a shift in program emphasis from loans to grants that has been necessitated by reduced funding levels in recent years. In FY 2000 when the General Assembly consolidated DBED programs to create the current MEDAAF program, the program was structured with an orientation to do loans. This was done with the intent to fund the program with $10 million annually for five years and then have the program be self-sustaining from repayments. MEDAAF has not been fully capitalized as originally anticipated, between FY 2000 and FY 2003, the General Fund (GF) appropriation totals $29M. Due to budget constraints in FY2003 & FY 2004, MEDAAF received GF of only $2 million and $4 million was transferred out the fund by DBM for budget reconciliation purposes. As a result, the only option has been for the program to be oriented to grants which do not create a repayment stream.

As to the accuracy of the FY 2004 & 2005 estimates for repayment, they were developed based on the best available data at the time.

DLS recommends that DBED and MDE brief the committee on the budgetary and programmatic impacts of the Governor's proposed Brownfields legislation and the potential benefits of consolidating the oil contamination program and VCP.

The quantifiable budgetary impacts of the proposed Brownfields legislation are in the area of fee income for MDE and the resultant ability for MDE to use the funds to support staff increases. While this is best addressed by MDE, DBED is supportive of this as it will enable MDE to shorten response times for applicants to the VCP and increase the enforcement efforts for sites that are not being dealt with by responsible persons. DBED also supports the concept of having one program to deal with VCP and oil sites. The concept will allow for increased efficiency at MDE and will be more user friendly by providing one point on entry to the MDE programs.

DBED would welcome the opportunity to brief the committee on the proposed Brownfields legislation.

DLS recommends that MDE brief the committees on the extent to which the additional fee and penalty revenue generated by the proposed Brownfields legislation would offset the need for general funds. It is further recommended that four new State Superfund Program positions in the fiscal 2005 allowance be deleted since they are not consistent with the recommendation of Spending Affordability Committee for new position growth.

DBED's budget is not impacted by this issue, however, DBED recognizes the positive impact the staffing will have for the business, as well as, the environmental community and supports the request by MDE. As stated previously, the increased staff is essential to reduce response since for applicants to the MDE program and for enforcement efforts.

DLS recommends that DBED brief the committees on the benefits of clarifying the statue to more clearly define who is an "inculpable person" vs. who is considered a "responsible person" and why only 9 of 24 Maryland counties are willing to participate in the program.

The Environmental Article defines "inculpable person" and "responsible person". These two defined terms are essential to determining sites that are eligible for the different incentives under MEDAF's Brownfields Revitalization Incentive Program (BRIP). Confusion has been created in the past by the Environmental Article 7-201(x) (2) that lists persons/entities that are not considered responsible persons. The proposed Brownfields legislation would codify the current administrative interpretation that persons/entities considered not to be included as responsible persons must by process of elimination be inculpable persons. Clarifying this interpretation will enable more sites to participate in the BRIP program. Of particular importance to DBED is the inclusion of sites owned by the State, political subdivisions, or their instrumentalities. Clarification of this interpretation will provide access to governmental entities that acquired property with the intent to remediate or redevelop.

To date, eight counties, the City of Baltimore, and five municipalities have elected to participate in BRIP. Additionally, three counties are actively considering participation.

The statutory prerequisites to using BRIP are either (1) providing a list of the jurisdiction's priority Brownfields sites or (2) enacting a Brownfields Property Tax ordinance pursuant to the Tax Article 9-229. Option (1) has never been used by a jurisdiction because of the difficulty in identifying sites and the potential impact on site owners. Option (2), which to date has been used by all participants requires that for a five year period 30% of the new taxes on a redeveloped site be remitted to MEDAF for future BRIP use. This requirement has been a point of resistance with jurisdictions both from a fiscal standpoint and an administrative burden standpoint.